IN THE

Supreme Court of the United States

OCTOBER TERM, 1977

No. 77-291

SECURITIES AND EXCHANGE COMMISSION, *Petitioner*,

v.

ARTHUR LIPPER CORPORATION AND ARTHUR LIPPER III

RESPONSE TO PETITION FOR A WRIT OF CERTIORARI TO THE UNITED STATES COURT OF APPEALS FOR THE SECOND CIRCUIT

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INTRODUCTION

Arthur Lipper Corporation and Arthur Lipper III, respondents in an administrative proceeding conducted by the Securities and Exchange Commission ("SEC"), have petitioned this Court for a Writ of Certiorari to the United States Court of Appeals for the Second Circuit to review that portion of the judgment of the Court of Appeals which affirmed the SEC's finding that Arthur Lipper Corporation and Arthur Lipper III (referred to herein as the "Lipper Respondents") had aided and abetted a violation of the SEC's Rule 10b-5. See Petition for Writ of Certiorari No. 77-275, filed in this Court on August 18, 1977.

The Petition of the Lipper Respondents raises significant issues regarding international jurisdiction, conflicts in governing law and administrative agency practices concerning an expansive interpretation of the SEC's Rule 10b-5; a rule which this Court recently considered. See *Santa Fe* v. *Green*, —— U.S. —— No. 75-1753, 97 S. Ct. 1293 (March 23, 1977); *Ernst & Ernst* v. *Hochfelder*, 425 U.S. 185 (1976); and *Sanders* v. *John Nuveen & Co.*, 425 U.S. 929 (1976), remanded 554 F2d 790 (CA 7, 1977). For the reasons more fully developed in their Petition, the Lipper Respondents urge this Court to grant certiorari on these issues. The decision of the Court of Appeals runs counter to this Court's interpretation of the SEC's Rule 10b-5. Moreover, the SEC has recently held that scienter, an element found necessary by this Court in the *Hochfelder* case to establishing a violation of Rule 10b-5 in a private litigation, is explicably not an essential ingredient when the SEC applies Rule 10b-5 in its own administrative proceeding. See *In re Steadman*, CCH Fed. Sec. L. Rep. Current Volume ¶ 81,243.

The SEC has recently been specifically instructed to consider the application of *Hochfelder* by the Court of Appeals for the District of Columbia in remanding to the SEC a broker-dealer, Rule 10b-5 appeal. *Collins* v. *Securities Corp.*, ——F2d —— (CADC No. 75-2200, August 12, 1977), CCH Fed. Sec. L. Rep. Current Volume ¶ 96,122.

In contrast to the primary issue raised in the Lipper Respondents' Petition—namely the obligations under Rule 10b-5 of members of the New York Stock Exchange ("NYSE") and the securities brokerage community in their relationships with institutional invest-

ors—the instant Petition of the Solicitor General filed on behalf of the SEC simply reflects the SEC's anger with the Court of Appeal's "audacity" to disagree with the vengeful and most severe penalty the SEC imposed upon the Lipper Respondents. Although the Solicitor General stresses the importance of administrative discretion in the selection of remedy, the real issue is the extent reviewing courts will tolerate agency abuses where the agency combines the roles of arresting officer, prosecuting attorney, judge, jury, as well as appellate tribunal.[1]

The Lipper Respondents urge that whether they are barred permanently from participation in the securities business, the punishment inflicted by the SEC, or whether they are only subjected to the retroactive 12-month suspension imposed by the Court of Appeals, is not an issue warranting this Court's review.

Since 1969 when the Lipper Respondents had their first opportunity to settle this matter with the SEC through the common, SEC staff-desired procedure of "consenting" to a finding of wrongdoing (without admitting the allegations) and accepting a mild sanction of little economic significance, the Lipper Respondents' overriding concern has been one of reputation, and their regard for applicable law. Thus, the Lipper Respondents continue to assert their right to defend

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[1] Indeed, the Court of Appeals for the District of Columbia has recently held that the standard of proof in an SEC broker-dealer, Rule 10b-5 proceeding, such as the one in issue here, is "clear and convincing evidence" not "preponderance of the evidence" because the severity of the sanction "renders the proceeding quasi-criminal in nature". *Collins v. Securities Corp.*, —— F2d —— (CADC No. 75-2200, August 12, 1977), CCH Fed. Sec. L. Rep. Current Volume ¶ 96,122 at 92,045.

against the SEC's total disregard of the fact that the Lipper Respondents were acting in an independent professional capacity vis-a-vis IOS, the SEC's major target. The Lipper Respondents never doubted the SEC staff's ability to guide whoever was then sitting as SEC commissioners to the ultimate objective sought by the staff, *i.e.*, damaging IOS in all respects, even to the extent of attempting to ruin an independent organization, which was providing non-U.S., bonafide financial institutions with securities brokerage services. In obviating any economic consequence of the sanction, the Court of Appeals selected the easy way out and avoided full consideration of the basic issues raised by the Lipper Respondents. The Court of Appeals effectively relieved the SEC from shouldering its burden of proof and at the same time avoided entering the murky waters of securities industry practice and SEC policies of eight years previous. Although relieving the Lipper Respondents of the effects of the SEC sanction, the Court of Appeals was unsuccessful in righting a wrong because the Lipper Respondents still suffer the stigma of a finding that they perpetrated an illegal act.[2]

REASONS FOR DENYING THE SOLICITOR GENERAL'S PETITION

Based upon his finding that the Lipper Respondents had aided and abetted in a violation of Rule 10b-5, the SEC's Administrative Law Judge (*i.e.*, the trial hearing examiner) proposed a 12-month suspension of the Lipper Respondents from the securities business. (39A)[3] The SEC chose to accept staff recommended

[2] A direct consequence of the stigma is the assertion by the Internal Revenue Service that the shared commissions were illegal rebates resulting in a $761,195 tax claim.

[3] "A" refers to pages in the Appendix to the Petition of the

sanctions, to overturn its administrative judge, "an adjudicator of long experience and great acumen" (76A), and instead imposed the harshest possible penalty of a complete and permanent bar from the securities business. The SEC's action was based on the following conclusions:

1. "We think the likelihood of future misconduct by the Lipper Respondents sufficient to call for their exclusion from the securities business." (76A-77A)

2. The ". . . sanction will have a deterrent effect on other broker-dealers who may be inclined to participate in the fraudulent schemes concocted by investment company managers." (77A) [4]

The Court of Appeals specifically took cognizance of the prevailing precedents which have delineated the appropriate role a Court of Appeals plays in reviewing SEC penalty determinations. See page 25A. In so doing, the Court of Appeals correctly considered (25A, footnote 10) that an administrative agency's penalty should not be altered unless the penalty is "unwarranted in law or is without justification in fact", citing *American Power Co.* v. *SEC,* 329 U.S. 90, 112-13

Solicitor General. In actual fact, the Administrative Law Judge recommended that Arthur Lipper Corporation be suspended for 12 months from executing transactions in the over-the-counter market only, thereby permitting Arthur Lipper Corporation to continue executing transactions on all national securities exchanges. Mr. Lipper would have been barred from association with the firm for the 12-month period.

[4] In this latter respect, the SEC noted (75A, fn. 69) that it declined to follow the Sixth Circuit's decision in *Beck* v. *SEC,* 430 F2d 673 (CA 6, 1970).

(1946) and *Butz* v. *Glover Livestock Commission Co. Inc.,* 411 U.S. 182 (1973). In other words, the Court of Appeals was fully aware of this Court's rule that an administrative agency's choice of sanction may be altered only when the reviewing court is satisfied that the administrative agency has abused its discretion. The court applied that rule to the facts of this case.

The Court of Appeals found the SEC's penalty "was too severe" (26A) and *"under the circumstances of this case . . . an abuse of discretion."* (28A) (emphasis added). As noted by the Court of Appeals, the SEC's penalty was not necessary to prevent the Lipper Respondents from participating in give-up arrangements because customer directed give-ups, the practice herein involved, had been abolished in December 1968. In addition, the Court of Appeals was aware of the SEC's recent concession (in an *amicus* brief filed in another case pending in that court) that the period in question (namely 1967 and 1968) "were years of considerable uncertainty as to the regulatory climate concerning give-ups" (27A); indeed, as the record of this case makes clear, give-up arrangements of all kinds pervaded the securities industry and were almost universal in the case of investment companies.

In fact, the SEC was a leading contributor to this uncertainty. During this period of time the SEC was in the forefront of the battle to require the national securities exchanges to ban give-up arrangements as inconsistent with the exchanges' fixed, minimum commission rate structure—the SEC's ultimate objective. It is not surprising that the SEC, as first an advocate and then a judge, would not consider this set of facts to be mitigating circumstances. It is for this very rea-

son that the fair and orderly administration of justice requires that a Court of Appeals be equipped to temper the enthusiasm of the overzealous administrative agency and bring to bear a more dispassionate overview to the proceedings. The SEC's capability of ruining reputations, businesses, and individuals must be controlled by a system requiring the dispassionate adherence to the laws protecting an accused. Neither legal nor moral right is always on the side of the regulator.

In measuring the penalty to be imposed upon the Lipper Respondents, the Court of Appeals pointed to many factors:

1. the Lipper Respondents "were living in a world of customer-directed give-ups". (27A)
2. "... many other competing brokers were directing" give-up payments to the same broker as the Lipper Respondents. (27A)
3. the Lipper Respondents "did act under the supervision of experienced although in our view not disinterested counsel". (27A) [5]
4. "... there is no evidence that they [the Lipper Respondents] had any thought they were violat-

[5] Both the Court of Appeals and the SEC made much of the fact that the counsel selected by Mr. Lipper was not disinterested since the same counsel had been retained by IOS, the adviser to the institutional customers of Arthur Lipper Corporation. However, it sometimes is forgotten that a businessman in good faith quite naturally seeks out the most knowledgeable and competent counsel who is familiar with the complicated legal ramifications of the securities business. Neither the SEC nor the Court of Appeals explained why the alleged "sins" of the counsel should be visited upon Mr. Lipper. The relationships were fully disclosed. The fact remains that Mr. Lipper, in good faith, relied upon the advice of knowledgeable and competent legal counsel.

ing the law—unless, of course, it were the law that any give-up on OTC [over-the-counter] business was fraudulent, which they had been advised, perhaps correctly, was not true." (27A)

5. "We are moved also by the inordinately long time in which this proceeding has been pending, particularly the unexplained lapse of over three years from the argument to the decision of the Commission [and] the cloud that has hung over petitioners' heads during this period." (27A)
6. Another consideration was "the tremendous disparity between the sanctions invoked against petitioners and that imposed on two other brokers whose violations were perhaps more clear". (27A)
7. The Court of Appeals believed that "some weight may properly be given to his [the Administrative Law Judge's] opportunity to observe Lipper and others who played a part in the acts here in question and in fashioning a remedy in light of that observation". (27A-28A)

Based upon the foregoing detailed listing of the circumstances of this particular case, the Court of Appeals quite appropriately concluded that the severe sanction selected by the SEC was an abuse of discretion. Hence, in reviewing the remedy selected by the SEC, the Court of Appeals meticulously followed the controlling precedents of this Court.

The SEC apparently does not contend openly that its selection of a remedy may never be overturned by

a reviewing Court of Appeals. However, it is hard to imagine the circumstances in which the SEC would agree that a Court of Appeals acted properly in overturning an SEC penalty. See *Beck* v. *SEC*, 430 F2d 673 (CA 6, 1970), which the SEC declines to follow. However, the Solicitor General argues (Petition p. 9) that the Court of Appeals failed to follow this Court's decision in *Glover Livestock, supra,* because the Securities Exchange Act of 1934 "reflects a congressional recognition that expulsion is generally the appropriate sanction for a serious violation . . ." and the "court of appeals did not question the seriousness of the respondents' violations".

The Solicitor General is wrong on both counts. First, the range of sanctions in the statute[6] merely means that Congress gave the SEC a wide choice of remedies —it would only suggest to the most prejudiced mind that by providing for a wide selection, the Congress intended that the SEC always impose the most harsh sanction. Secondly, a cursory glance at the factors we have listed above which the Court of Appeals found were the circumstances which led the court to reduce the permanent expulsion, demonstrates that the Court of Appeals did not share the SEC's view of the seriousness of the conduct of the Lipper Respondents. Inescapably involved in this case is the fact that the SEC had criticized the self-regulatory bodies governing the securities industry (*i.e.,* the New York Stock Exchange, other national stock exchanges and the National Association of Securities Dealers) for authorizing and promoting give-up practices among members

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[6] Section 15(b)(4)(E) of the Securities Exchange Act of 1934, 15 U.S.C. (Supp. V) 78o(b)(4)(E).

of the brokerage community. Also, it is unquestioned that the SEC at all times had the authority to adopt a rule banning give-ups, an alternative it failed to select. This state of the law in 1967-1968 was a significant factor in the advice given to the Lipper Respondents by their counsel.

Because of the SEC's failure to adopt a rule banning give-ups, the SEC staff attempted to "prove" violations of the SEC's Rule 10b-5 on "evidence" that the SEC had declared over-the-counter give-up arrangements unlawful in statements in various SEC studies and in a letter written by an SEC staff official. See the Court of Appeal's discussion of this SEC tactic at pages 8A-11A. The Court of Appeals quite properly overruled the SEC's findings that such statements constitute evidence of fraud *per se*. But it is understandable that the SEC was incensed that a member of the regulated brokerage community accepted the opinion of its independent counsel, himself a former high official of the SEC, that statements in SEC studies are views and do not have the force of law. In the absence of a rule banning give-ups, which the SEC had at all times full authority to adopt, counsel's client could accept the opinion that they were acting in conformity with the law.

It was not until the Lipper Respondents introduced into the record of this administrative proceeding evidence that members of the NYSE uniformly charged all clients the same NYSE minimum commission rate on all over-the-counter agency transactions that the SEC was reluctantly forced to acknowledge this fact. By recognizing the universal application by NYSE members of charging the NYSE minimum commission

rates on over-the-counter agency transactions, the Court of Appeals rejected the SEC's contention that the Lipper Respondents had the legal obligation to negotiate reduced brokerage commissions. It is clear that had the Lipper Respondents retained the full commissions charged, the effect on the shareholders would have been identical to that which actually occurred. Were there not to have been a sharing of commissions as permitted and encouraged by the self-regulatory bodies, the SEC would have had no cause for complaint. In addition, the Court of Appeals would not have had an opportunity to advance its unique interpretation of law imposing new responsibilties on independent brokers to police the fiduciary responsibilities of the investment adviser (IOS) to the broker's clients; even clients domiciled outside the United States.

Finally, it is noteworthy that the prior SEC statements were those of a regulator advocating a change in accepted industry practices; the statements were not issued in the SEC's judicial capacity. And when the SEC brought this case against the Lipper Respondents, it selected its own forum, electing not to bring an injunctive action before a disinterested district court judge—an avenue clearly available to the SEC.

It is this very kind of situation which requires a reviewing Court of Appeals to temper the zeal of the administrative agency which is out to justify its prior pronouncements as a regulator, when such pronouncements are called into question and come before the agency in its judicial capacity. However necessary it may be to the administration of justice to permit the regulator to be both prosecutor and judge, a reviewing court must be alert to the abuses which frequently can follow from this inherent weakness in the administra-

tive process. Moreover, this is not a situation involving a complex financial restructuring of an industry where the expertise of the SEC need prevail.

The contention that the Lipper Respondents had to be permanently barred from the securities industry because of the likelihood of their future misconduct was patently unacceptable to the Court of Appeals. The Court of Appeals pointed out that give-up practices were banned by the self-regulatory bodies in December 1968 and not through SEC rule-making; and, therefore, public investors had nothing to fear in this regard. Moreover, the Solicitor General has not explained why the SEC was willing to accept settlements imposing suspensions of 15 calendar days and 21 business days on other broker-dealers who participated in conduct which was more clearly a violation than the conduct of the Lipper Respondents. If the SEC is really concerned about the deterrent value of the penalties it imposes, it would seem that the other broker-dealers should have also been permanently barred. And it is in this context that the Court of Appeals undoubtedly noted the disparity of sanctions imposed; for the disparity completely destroys the SEC's "deterrent theory".

The real fact is that the SEC's entire enforcement program depends upon "consent cases". A businessman who finds himself engaged in an SEC litigation makes a practical judgment that if he is to continue in business he must "play ball with the SEC" and consent. The businessman, of course, avoids the enormous costs connected with protracted litigation with the SEC and the attending adverse publicity. Moreover, he is allowed to consent without admitting the SEC's

allegations. From the SEC's standpoint, a consent order is a complete "victory", particularly where the consent includes an agreement that the SEC may write an opinion. New precedent can be established without benefit of the traditional adversary system and the scrutiny of judicial review by a truly disinterested body. But, where as here, a respondent sincerely believes it is his unfettered legal right to seek vindication by refusing to consent and demands that the SEC *prove* its case, the agency must teach others of like persuasion that exercise of one's rights in the administrative forum can be a dangerous and costly proposition. Others are taught a clear lesson—anyone, including attorneys, who fail to knuckle under to the will of the prosecuting staff members can expect continued harrassment, antagonistic treatment and when possible in the staff's power the harshest of sanctions. "Consenting" has become the expedient for the businessman unwilling to accept the cost and attendant publicity of challenging the SEC.

CONCLUSION

For the foregoing reasons the Lipper Respondents urge this Court to deny the Petition of the Solicitor General. The Lipper Respondents believe that the issues raised in their Petition No. 77-275 warrants review by this Court. In any event, it would be a gross miscarriage of justice to grant the Petition of the Solicitor General and at the same time deny the Petition of the Lipper Respondents.

Respectfully submitted

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